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JAPAN'S EMERGING ROLE IN INTERNATIONAL FINANCIAL MARKETS

Summary

Japan remained the world's largest international creditor in 1989, but the growth of its net assets slowed dramatically. Moreover, the weakness of Japanese domestic financial markets this year is casting a long shadow on Japanese financial activities worldwide and has led some analysts to conclude wrongly that Japanese firms are supplying significantly less capital to world markets than previously.

Until 1981 the United States was the world's biggest international creditor. The dollar's important role in denominating international trade and cross-border financial assets coexisted with this creditor position. A few analysts have predicted the same future status for the yen. Despite the growing global financial clout of Japanese companies, the yen is used relatively little in international transactions, with the dollar continuing the dominance it has had throughout the postwar period. In many respects the dollar's strong role is an advantage for the United States, although it does bring commensurate responsibilities. Should the yen eventually achieve a significantly greater international status, similar costs and benefits would devolve on Tokyo.

Japan's Emergence as an International Creditor

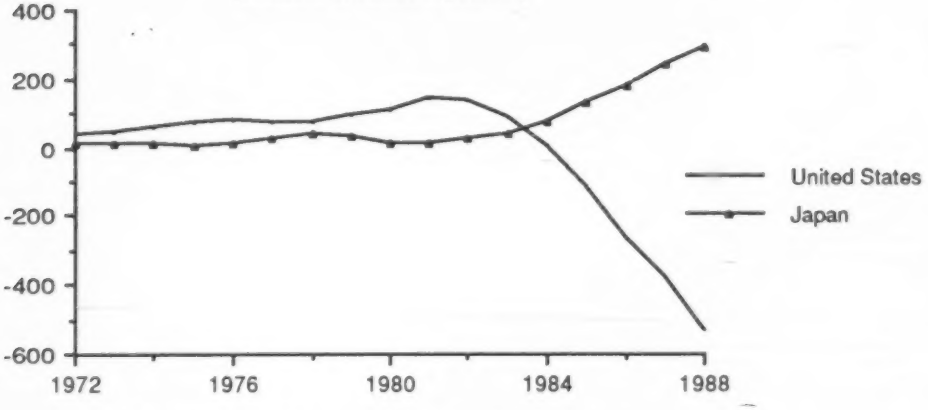
As the 1990s dawned American public opinion had grown accustomed to viewing Japan as the world's main creditor. From venture capital firms to municipal governments, Americans appeared to be going cup in hand to Tokyo and

its financial powerhouses. The federal government, too, struggling to finance its budget deficit and its growing military force in the Persian Gulf, pressed Tokyo for international financial commitments. Some press reports even suggested that Japanese investors had life or death say over U.S. financial markets.

These arguments resonated particularly strongly because the United States had become the world's largest debtor (see Figure). While many experts, including those in the Department of Commerce who assemble the components of this country's international financial balance sheet, believe that the data exaggerate America's debtor status, few doubt that the U.S. position deteriorated significantly during the 1980s.

Net International Investment Positions

(in billions of dollars at yearend)



Source: Bank of Japan and Department of Commerce

Japan's role as the world's largest creditor, however, does not mean that it has a commensurate role as supplier of new funds to world capital markets in a given year. Moreover, the rate of growth of Japan's overseas assets slowed dramatically in 1989, suggesting that the popular image of Japanese financial institutions as the world's financiers was considerably exaggerated. Furthermore, being the largest creditor has not immunized Japanese markets from financial shocks. Japan's stock market, which some analysts reckoned had enjoyed a 20-year run of rising prices has plummeted this year, enabling the New York Stock Exchange to reclaim its title from the Tokyo Stock Exchange as the world's largest. As of mid-September the total market value of stocks on the Tokyo Stock Exchange was lower than at any time since June 1987.

Sources of Japan's International Financial Clout

Japan's position as the world's largest creditor is closely related to its balance of payments. A surplus of exports over imports implies net overseas investment. Japan's diminishing current account surplus, which has dropped by more than one-third in dollar terms since peaking in 1987, corresponds to a

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smaller outbound capital flow. Both the current account and net investment depend on the relationship between savings, investment and government spending in the economy. Between 1985 and 1989 Japanese personal savings rates dipped slightly and plant and equipment spending boomed, suggesting a reduction in the private-sector imbalance, which actually became negative in 1989. However, the fiscal balance, the amount made available on capital markets by the actions of central and local governments, grew substantially. The net result was a decline in surplus savings available for investment abroad (see Table 1).

Table 1: Current Account and Government and Private Domestic Imbalances in Japan, United States and West Germany

(percent of GNP)

	1981	1986	1989
Japan			
Current Account	0.4%	4.3%	2.0%
Fiscal Balance*	-3.8	-0.9	2.8
Private Net Savings**	4.4	5.3	-0.5
Discrepancy***	0.2	0.1	1.3
United States			
Current Account	0.3	-3.1	-2.0
Fiscal Balance*	-1.0	-3.4	-2.0
Private Net Savings**	1.1	0.2	0.8
Discrepancy***	-0.2	-0.1	0.8
West Germany			
Current Account	-0.5	4.4	4.4
Fiscal Balance*	-3.7	-1.3	0.2
Private Net Savings**	3.1	5.7	4.2
Discrepancy***	-0.1	0.0	0.0

*Central and local governments.
**Gross savings in business and household sectors minus gross investment in business and household sectors.
***Rounding error, statistical discrepancy in the national accounts and coverage differences between national income and current account data.

Source: International Monetary Fund, World Economic Outlook (May 1990).

The United States has experienced the opposite movement: the fiscal imbalance deteriorated rapidly in the early 1980s, although it has improved somewhat in recent years. The surplus of the private sector shrunk between 1981 and 1986, leading to a continuing large capital deficiency, made up by Japan and other nations. While the Japanese surplus available to the United States and other countries declined relative to gross national product between 1986 and 1989, the West German surplus remained unchanged, and at the end of the decade

was twice as large relative to GNP as the Japanese surplus. Since Japan's economy is much larger than West Germany's, their current accounts in dollar terms were nearly identical in 1989: a surplus of $57.2 billion in Japan against $52.8 billion in West Germany. As such, the two nations could make almost equal claims last year to the title of world's financier.

With German reunification the West German current account surplus could fall dramatically. Moreover, if Japan's surplus continues to drop and U.S. demands grow to finance its budget deficit -- made possibly much worse if the United States enters a recession -- worldwide capital markets could well tighten. As a result, inflation-adjusted interest rates could rise significantly.

Components of Japan's International Assets

Until regulatory changes made outbound capital flows substantially easier for Japanese firms beginning in 1981, most of Japan's net assets abroad were in the government sector. (For details of Japan's financial liberalization regarding overseas capital flows, see JEI Report No. 42A, November 3, 1989.) As Table 2 shows, government assets abroad exceeded those in the private sector until 1984.

Table 2: Japan's Net External Assets, 1972-89

(in millions of dollars)

End of Year	Private Sector	Government Sector	Total
1972	$-6,820	$20,687	$13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821
1986	138.541	41,810	180,351
1987	146,494	94,250	240,744
1988	147,571	144,175	291,746
1989	158,839	134,376	293,215

Source: Bank of Japan, Balance of Payments Monthly, April 1990.

The rapid depreciation of the dollar against the yen and other key international currencies between 1985 and 1988 ushered in another change. Japanese firms attempting a balance between yen- and dollar-denominated assets in

their portfolios had to add more dollar assets to obtain a given mix since the dollars corresponded to fewer yen than previously. In addition, interest rate differentials favored dollar assets. The result was a surge of private-sector foreign holdings denominated in dollars in 1985 and 1986. In 1987 and again in 1988 private investors slowed down the shift of assets abroad, reflecting both progress in portfolio reallocation and the realization that dollar-denominated assets were subject to considerable exchange rate risk as the dollar continued to fall in value. The data hint that the Bank of Japan substituted for these private investors as a source of demand for dollar-denominated assets, thereby slowing the dollar's fall in both years. This apparent BOJ action probably accounted for the surge in net foreign official assets in 1987 and 1988.

In 1989 the relative roles of the public and the private sectors switched again. Now it was the yen's turn to weaken, averaging Y138=$1.00 last year against Y128.2 to the dollar in 1988. This turn of events pleased private investors who, if they opted for dollar-denominated assets, faced the potential for a double-barrelled gain: currency appreciation and higher interest rates. As the dollar gained strength on the basis of this self-fulfilling prophecy, the Bank of Japan appeared to lean against the wind, selling dollar-denominated assets and reducing its foreign exchange reserves. As a result, government net external assets dropped slightly in 1989, while private-sector assets rose.

Partial data for 1990 are available for Japan's foreign exchange reserves but not for other public- or private-sector assets. These reserves, which stood at $84.9 billion at the end of 1989, dropped further during the first four months of this year, bottoming out at $73 billion April 30, a move that coincided with a period of weakness for the yen. The Japanese currency averaged Y158.5=$1.00 for April, its worst showing since December 1986. In more recent months foreign exchange reserves have risen along with the yen, hitting $75.3 billion in September when the yen averaged Y139=$1.00.

Table 3 shows a breakdown of Japan's external assets and liabilities in 1988 and 1989. The country's net securities position actually declined last year, falling from $172.3 billion to $159.8 billion or 7.3 percent, even though yearend holdings of foreign securities increased sharply from $427.2 billion to $533.8 billion. The drop in net assets probably resulted from increased Japanese corporate fund-raising in international capital markets, reflected in the figures by the jump in liabilities under the stock and bonds heading. For example, the value of international bonds outstanding issued by Japanese entities rose from $184.2 billion in 1988 to $266 billion in 1989, according to the Bank for International Settlements.[1] The international bond market drew considerable strength from equity-related bonds; with the drop in the Japanese stock market in 1990, however, this portion of the international bond market has virtually disappeared because the right to obtain equities on favorable terms has become much less valuable.

In short, in 1989 both the asset and the liability figures for securities jumped, reflecting the internationalization of Japanese capital markets. While comparable 1990 data are not available, the growth of liabilities and assets appears to have dropped sharply. For example, Japanese balance of payments

[1]Bank for International Settlements, 60th Annual Report (Basle, Switzerland: 1990), p. 145.

Table 3: Japan's External Assets and Liabilities, 1988 and 1989

(in millions of dollars)

	Assets		Liabilities	
	End of 1988	End of 1989	End of 1988	End of 1989
Long-Term	$832,669	$1,019,218	$311,625	$447,472
Private Sector	728,168	901,736	268,431	405,498
Direct Investments	110,780	154,367	10,416	9,160
Trade Credits	48,791	52,866	23	16
Loans	123,663	137,084	1,061	18,895
Securities	427,218	533,781	254,886	373,990
Others	17,716	23,638	2,045	3,437
Government Sector	104,501	117,482	43,194	41,974
Loans	55,570	60,471	26	7
Others	48,931	57,011	43,168	41,967
Short-Term	636,678	751,785	865,976	1,030,316
Private Sector	538,802	666,712	850,968	1,004,111
Monetary Movements	502,256	627,846	765,165	894,679
Others	36,546	38,866	85,803	109,432
Government Sector	97,876	85,073	15,008	26,205
Monetary Movements	97,869	85,072	5,144	16,957
Others	7	1	9,864	9,248
Total	1,469,347	1,771,003	1,177,601	1,477,788

Source: Bank of Japan, Balance of Payments Monthly, April 1990.

data for the first six months of 1990 show that Japanese investors purchased a net $10.2 billion in U.S. Treasury and other foreign bonds, down from $39.1 billion a year earlier. Overseas liabilities also grew more slowly, a result of much less fund-raising by Japanese firms on international money markets and net withdrawals by foreigners from the Japanese stock market. As a result, the net long-term capital outflow dropped to $34.8 billion in the January-June 1990 period from $36.4 billion a year earlier. (For details, see JEI Report No. 33B, August 24, 1990.)

This development has considerable significance for policymakers and contradicts another argument making the rounds in Washington and Tokyo. Juxtaposing balance of payments data that show a drop in Japanese purchases of stocks and bonds worldwide with an apparent net decline of $8.9 billion in Japanese assets held in the United States from January through June of this year, some American and Japanese analysts have sounded an alarm. They fear that Japanese companies finally are staging their dreaded withdrawal from U.S. capital markets. The expected result is sharply higher U.S. interest rates in the wake of the reduced supply of funds, assuming that demand remains roughly unchanged.

This second argument has several obvious problems. First, any U.S. interest rate increase based on Japanese investors' January-June sell-off of U.S. assets already should have occurred. In other words, to the extent that the phenomenon means anything, the pressure for higher interest rates should have

begun months ago, not with the announcement of Japan's international payments data in early September. Second, the data used to make the alarmist argument fail to note the other aspects of Japanese international capital flows considered above: the decline in outbound flows was almost matched by a decline in inbound flows. Hence, the net flow -- the amount available to finance activity abroad -- changed little in the first half of the year. Third, the decline in the Japan-U.S. capital flow by itself was almost meaningless. Sources and uses of funds are largely interchangeable; if Japanese investors decide to abandon U.S. assets in favor of those in Europe and elsewhere, then the funds they replace in those third-country markets are available for financing activity in the United States. For these reasons it is no surprise that U.S. interest rates failed to rise significantly between January and June of this year when Japanese funds were being pulled out of U.S. securities markets.

In addition, the wider economic implications that some experts have drawn from Japan's international payments data is incorrect. A number of Japanese analysts have suggested that the apparent abandonment of U.S. capital markets is further evidence of American decline. In fact, recent changes in international money markets have at least as much to do with the fragility of Japanese capital markets. The slowdown in the growth of Japanese international liabilities in 1990's January-June period was largely a consequence of foreign unwillingness to bet on a recovery of the Japanese stock market. In other words, the drop in the growth of both Japanese foreign assets and liabilities at this year's midpoint cannot be assumed to be a result solely of problems in the Amercan economy. The difficulties in Japan's financial markets also played a role.

More generally, the movement of securities between the United States and Japan in 1990 suggests that stock and bond investors on both sides of the Pacific have retreated to their respective home markets. American stock investors, for example, appear to have switched some of their portfolio from Japan to the stronger market on Wall Street. Japanese bondholders increasingly prefer domestic government bonds rather than U.S. bonds. With the nominal interest rate differential between American and Japanese issues less then half a percentage point, Japanese bond investors in effect pay only a slight penalty for avoiding exchange rate risks.

The data in Table 3 and elsewhere do not support a broad conclusion that Japan is becoming significantly less involved as a global investor. For example, as Table 3 shows, Japanese direct investment abroad soared 39.4 percent in 1989. Balance of payments data for 1990 suggest that foreign direct investment grew at least as fast in dollar terms in the first half of this year, although the amount of direct investment outstanding grew slightly more slowly in percentage terms.

Finally, as noted above, world capital markets could tighten in coming years. This raises the possibility that higher interest rates could serve as a magnet pulling funds out of Japan to meet capital shortages elsewhere. Should this happen, Japan's international role as a creditor could expand significantly. Of course, such a scenario would presuppose larger surplus savings in Japan, a development by no means guaranteed.

Internationalization of the Yen

The foregoing argument suggests that Japan is likely to remain a key player in world financial markets despite recent ups and downs of international

stock and bond markets. Many observers in Japan, and some in the United States, have argued that Japan should take another step -- internationalize the yen. This would raise its economic profile and possibly also give it increased political clout. While Japan's economic role has increased internationally, that of its currency has changed only marginally up to now. As a result of the international trading regime put in place after World War II, the dollar continues to play the preeminent role in international finance, with supporting roles for other currencies.[2]

"Internationalization" is a term to which several meanings can be applied. Each of these is considered below.

Opening Up Japanese Capital Markets - During the 1984 yen-dollar talks between Japan and the United States, American negotiators essentially argued that foreign investors had only limited means of betting on a rise in the value of the yen. As a result, the yen was said to be undervalued. One product of those talks was progress toward establishing new financial instruments. However, as many critics had predicted, the principal immediate result of financial liberalization in Japan was that outbound capital flows became easier, which led to an increased demand for dollars -- not yen -- with the consequence that the American currency strengthened against the yen. These capital flows, of course, are one of the reasons Japan emerged as the world's largest creditor.

To date, however, a key component of internationalization in this sense had not yet been put in place. Financing bonds, the most important short-term Japanese government security, still are not widely traded and are issued with below-market interest rates, dramatically reducing their appeal for foreign and Japanese investors alike. (The Bank of Japan ends up holding a disproportionate share.) These instruments, as a safe and a potentially highly liquid type of security, normally would be considered a principal means by which foreigners could place bets on the yen; equivalent securities perform this function in the United States regarding the dollar. However, the Ministry of Finance, which probably would have to pay higher interest rates to attract investors, has resisted successfully both foreign and Bank of Japan pressure to introduce changes in this instrument. (The characteristics of FBs also have implications for the conduct of Japanese monetary policy and for relations between MOF and BOJ. For details, see JEI Report No. 27A, July 13, 1990.)

Using the Yen to Denominate International Financial Assets - As noted above, Japanese investors expose themselves to exchange rate risks if they buy dollar-denominated bonds or other financial assets. If the dollar falls between the time they buy the securities and when they sell, they probably will suffer a loss. While various kinds of hedging techniques are possible for many dollar assets, denominating the bonds in yen in the first place obviously would be simpler from the Japanese buyer's standpoint. If the issuer has close relationships with the Japanese companies that effectively set prices in yen, then interest and principal payments also may be less risky for the issuer if the

[2]For a summary of the dollar's international role using concepts generally similar to those employed below, see Peter B. Kenen, "The Role of the Dollar as an International Currency," Group of Thirty Occasional Papers, No. 13 (New York: 1983).

bonds are denominated in yen. Japanese corporations operating overseas obviously fall in this category, as do at least a handful of American firms.

Table 4 shows new issues of yen-denominated international bonds in recent years. From 1986 to 1989 yen-denominated issues showed no consistent gain compared to their dollar-denominated counterparts, although they ranked second to dollar issues in each year except 1987 when they were the largest. Comparable data are not available for the years before 1986, but the yen-denominated share apparently almost doubled between 1983 and 1986.

Table 4: Composition of International Bond Issues, 1986-89

(percentage of total fixed-rate net new issues)

	Total (billions of dollars)	Percentages			
		Dollars	Yen	Pound Sterling	Others
1986	$108.6	42.3%	17.4%	4.5%	35.7%
1987	68.9	15.5	26.7	11.9	45.8
1988	99.4	26.8	12.0	10.5	50.9
1989	89.0	29.1	16.2	12.4	42.2

Source: Bank for International Settlements

Table 5 shows a different dimension of international assets. The composition of foreign currency holdings of banks reporting to the Bank for International Settlements has shown a sharp, fairly continuous swing to the yen in recent years. While the dollar remains dominant, the yen now occupies second place in BIS reported-bank holdings, ahead of the Deutsche Mark. On balance, therefore, the data in Tables 4 and 5 suggest a movement, but not a stampede, toward the yen.

Yen-Denominated Exports and Imports - Traditionally the dollar has reigned supreme in trade to a remarkable degree worldwide. For example, even North Korea, arguably among the world's most hostile nations to the United States, has used the American currency to denominate much of its trade, although relations between Washington and Pyongyang are virtually nonexistent. Japan uses the dollar for trade even when that trade involves third countries; one estimate for 1980 put the dollar-invoiced share of Japanese exports to countries other than the United States at 75 percent.[3]

The prevalence of the dollar makes sense given the U.S. role as the world's largest trader. Both parties to a transaction can minimize risk by using dollars if their remaining costs and revenues are in dollars. For Japanese firms, however, this typically is not the case; most of their costs are in yen. Hence, a dollar-denominated trade contract between an American firm and a Japanese one imposes currency risks on the Japanese company. A Japanese firm can avoid this risk by hedging, but hedges are not costless.

[3] Ibid., p. 10.

Table 5: Currency Composition of Cross-Border Positions, 1986-89*

(in billions of dollars; changes in asset levels excluding exchange rate effects)

	1986	1987	1988	1989
U.S. Dollar	$188.8	$184.1	$94.6	$137.8
Japanese Yen	20.8	30.7	14.0	38.8
Deutsche Mark	0.9	31.1	31.3	29.5
ECU**	6.2	8.2	15.6	16.4
Pound Sterling	8.5	5.2	22.8	15.7
Swiss Franc	7.9	-1.5	-4.8	2.7
Other	25.2	27.3	39.7	49.9
Total	258.3	285.1	213.2	290.8

*BIS reporting banks.
**European Currency Unit

Source: Bank for International Settlements

A summary of a recent Ministry of International Trade and Industry survey indicated that 75.9 percent of the responding companies complained that exchange rate changes made planning difficult; 46.8 percent said plant and equipment investment decisions similarly were complicated. MITI did not say how the surveyed firms were selected or whether they had a greater than average exposure to foreign trade.[4]

Table 6 shows how the yen's role has changed in Japan's international trade in recent years. Japanese exports are far more likely to be denominated in yen than imports; in part this reflects the fact that industrial and agricultural inputs, which make up nearly half of Japan's imports, are goods traded on international markets and priced in dollars, with crude oil being a prominent example. Earlier data are calculated on a different basis but appear consistent over a period of 20 years with an upward creep in the share of both exports and imports denominated in yen. Yen-denominated exports in 1975, for example, were about half their current share, while imports, at just 0.9 percent, were a fraction of their 1989 level.[5]

Despite the increased use of the yen in Japanese trade, the figures in Table 6 are much lower than equivalent figures for other large industrial countries. The United States invoices virtually all its exports in dollars; West Germany's figure came to 81.5 percent in 1987, the latest year for which data

[4]Ministry of International Trade and Industry, Tsusho Hakusho (Tokyo: Okura-sho Insatsu-kyoku, 1990), p. 95.

[5]For a summary of research on the role of yen in trade and a discussion of the progress of yen internationalization generally, see Jeffrey A. Frankel, The Yen/Dollar Agreement: Liberalizing Japanese Capital Markets (Washington, D.C.: Institute for International Economics, 1984), especially p. 37.

Table 6: Percentage of Japan's Trade Denominated in Yen, 1970-89

	Exports	Imports
-1970	0.9%	0.3%
1975	17.5	0.9
1980	29.4	2.4
1985	35.9	7.3*
1989	34.7	14.1

*Fiscal year.

Source: Fuji Research Institute

are available. Similarly, imports are several times more likely to be denominated in home-country currencies in the case of the United States and West Germany than in Japan's case.

The Japanese currency is used far more widely in transactions with some regions than with others. In 1988 only 17 percent of Japanese exports to the United States and 10 percent of its imports from this country were denominated in yen. By contrast, 37.6 percent of Japanese exports to South and East Asia and 17 percent of imports from that region involved yen-based transactions that year. These figures reflect in part the risk-averting advantages of trading in yen in countries where trade with Japan looms large. For example, a Malaysian exporter that uses imports from Japan in the manufacture of its product covers the higher dollar import prices resulting from possible yen appreciation if the company prices its exports in yen.

The Yen as a Reserve Currency - As noted above, both public and private investors stimulate international capital flows. Official actions often are taken to push an exchange rate in one direction or the other. If the Bank of Japan believes the dollar is too strong, for example, it may depress the value of the American currency artificially by making available dollars on international money markets. One reason it can do this is its reserve of dollars. Of course, in theory a central bank could use any number of currencies to intervene in foreign exchange markets and to hold reserves against the day that it runs balance of payments deficits, but in practice the dollar overwhelms other currencies in this respect.

Table 7 shows the trend in reserves. During the early 1970s the dollar lost ground as governments around the world diversified their foreign exchange holdings. More recently, the U.S. currency's share of reserves typically has risen or fallen with the value of the dollar on international currency markets. An appreciating dollar apparently implies less risk for central banks holding the American currency. In 1986 and 1987, however, this pattern was broken; the dollar's share of world foreign exchange holdings rose after authorities added to their dollar reserves as a means of supporting the greenback's value.

The ongoing dependence on the dollar as a reserve currency means that nations continue to rely on the United States as a banker. If the circumstances were right and Washington so chose, this mandate could amount to a license to print money. (Cynics have suggested this possibility explains why Washington

Table 7: Share of National Currencies in IMF Members' Official Foreign Exchange Holdings, 1973-88

	1973	1975	1980	1984	1985	1986	1987	1988
U.S. Dollar	76.1%	79.4%	68.6%	69.4%	64.2%	66.0%	66.8%	63.3%
Deutsche Mark	7.1	6.3	14.9	12.3	14.9	14.9	14.7	16.2
Japanese Yen	0.1	0.5	4.3	5.6	7.8	7.6	7.1	7.2
Pound Sterling	5.6	3.9	2.9	3.0	3.1	2.8	2.7	3.1
French Franc	1.1	1.2	1.7	1.0	1.3	1.2	1.2	1.7
Swiss Franc	1.4	1.6	3.2	2.1	2.3	1.9	1.6	1.5
Other	8.6	7.1	4.4	6.6	6.4	5.5	5.9	7.0

Source: International Monetary Fund, Annual Report.

took a leading role setting up the system this way in the aftermath of World War II.) If foreign central banks are willing to hold increased reserves of dollar assets, then the United States indefinitely is free to spend more than it earns in foreign trade. Other nations, rather than objecting to this apparent scam, may even welcome the development since the resultant higher foreign exchange reserves may help lubricate and expand international trade generally. The same would be true for transactions denominated in yen. MITI argues that internationalization of the yen would be desirable in part because it would permit trade to grow faster.[6] The risk is that the increase in reserves would become excessive, with inflated dollar (or yen) prices rather than increased trade.

Washington's role as a large international debtor -- and Japan's as a big creditor -- obviously creates problems when the dollar figures so dominantly. Rapid inflation in the United States could lead to a reduction in the real value of dollar-denominated assets around the world, reducing this country's real debt burden. As large creditors, Japanese firms and the Bank of Japan would be losers. For this reason alone, Tokyo would appear to have a strong interest in the yen playing a more prominent role. In any case, the American currency would appear to be a poor choice to dominate international transactions, yet other factors argue for keeping what may appear to be a fox in charge of the henhouse.

Costs and Benefits of Currency Internationalization

If central banks or private investors are willing to hold a currency as a store of value, the home country can reap profits from increases in the international use of its currency. This role could be in jeopardy, however, if the currency fails as a store of value -- because, for example, inflation in the issuing country is excessive compared to price increases in other countries. Hence, in order to preserve a currency's global position, the Federal Reserve Board and other central banks whose currencies have a reserve role presumably have to be more concerned about inflation than does a central bank on the periphery of international currency markets.

[6]MITI, op. cit., p. 96.

However, too tight a rein on inflationary forces would be equally counterproductive. In that case, a country like the United States or Japan probably would tend to run a balance of payments surplus. In such a situation partner countries would accumulate fewer foreign exchange reserves -- particularly in the inflation-fighting nation's denomination -- and less liquidity would be available to the international trading system; trade flows could stagnate. With mammoth U.S. trade imbalances in recent years, few would accuse Washington of not doing enough to create liquidity in the system. This example also suggests why surplus countries like Japan may continue to play relatively small international financial roles; its trading partners do not accumulate yen reserves in part because they buy more from Japan than they sell.

The different dimensions of the internationalization of a currency are mutually reinforcing. For example, if dollar-denominated assets are the rule in international financial markets, that fact clearly reinforces their role as foreign exchange reserves. If both private and public foreign financial assets are held mainly in dollars, central banks can substitute easily for private investors in capital markets if private investors abandon dollar-denominated instruments. As described above, the Bank of Japan appeared to play this role in 1987, increasing its reserves. Similarly, if dollars are used to denominate Japan's imports, as they generally are, Japanese firms have an additional reason to hold dollar-denominated financial assets in order to pay for foreign goods. Whenever trade is denominated in dollars, governments will tend to accumulate dollars as foreign exchange reserves, particularly if their country runs a current account surplus.

Given the interdependent roles of a key currency, the past dominance of the dollar as a currency for trade as well as a reserve currency and a private international financial asset is not surprising. The relationships among the different aspects of internationalization direct, in part, powerful forces that tend to concentrate attention on one currency at the expense of others, making it all the more difficult to dislodge a dominant currency like the dollar.[7]

Conclusion

Washington appeared eager during the 1984 yen-dollar talks to reduce its role as manager of the world's preeminent currency. Despite efforts to elevate the yen, the Japanese currency's importance has increased only modestly and the dollar's role diminished only slightly. Japanese policymakers would have had to face the prospect of taking international repercussions even more into account had the yen quickly achieved a much higher profile. That day is slowly approaching. In the meantime, the world's financial and trading systems depend, more than they otherwise would have, on decisions made in Washington. Given

[7]This argument is developed in the context of bank competitiveness by Gunter Dufey and Adrian Tschoegl, "International Competition in the Services Industries: Institutional and Structural Characteristics of Financial Services," prepared for the U.S. Congress, Office of Technology Assessment, Contract 533-5675.1, February 28, 1986, pp. 149-157. Authors Dufey and Tschoegl conclude that U.S. banks derive a modest competitive advantage from transactions in their home currency. Their argument would seem to suggest that internationalization of the yen might work against the competitive interest of U.S. banks.

Washington's status as the world's largest debtor, some might regard this situation as analogous to the fox supervising the henhouse. At this point, however, inertia and America's large trade imbalance work to preserve the status quo.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.